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Profits available for dividends

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Profits Available for Dividends

PROFIT and profits are broad terms. When the word "profit" is used without a qualifying word or phrase it ordinarily has a non-technical meaning and indicates the excess of proceeds over cost in a specific or incidental transaction, such as the sale of a bond at a price above cost. The word "profits" usually is used with some qualifying expression, such as "gross profits" or "net profits."

The general rule is that dividends must come from profits. Net profits as shown on a statement of income and profit and loss should represent the amount available for dividends and earned surplus. The accountant is faced with conflicting views as to what factors must be considered before arriving at a figure for the profits available for dividends.

The business man is interested in what are his profits available for dividends. Directors of corporations must know the amount of profits available for dividends in order not to declare illegal dividends and become subject to penalties imposed by law. The accountant's task is to set forth in financial statements for the directors the amount of net profit or the profits available for distribution. In the accomplishment of this work he must give recognition to the law in relation thereto and to the accounting problems involved.

One of the first questions to arise is whether profits, to be available for dividends, must be realized or may be unrealized. Most writers take the view that dividends must be based on realized profits. Collateral to this is the question of what constitutes realization. The average lawyer is likely to be of the opinion that nothing is profit until realized in cash. The accountant generally considers profit realized when a sale is made.

There is no question about the necessity or propriety of deducting from gross profits the ordinary operating expenses such as cost of supplies purchased, wages, fuel, light, heat, and, in general, all manufacturing, selling, and miscellaneous expenses for which cash is spent or a liability incurred. It seems fairly well settled also that accrued depreciation, interest, and taxes likewise must be deducted. Furthermore, in making any charge against profits, care must be taken that capital expenditures are properly distinguished from revenue expenditures.

In the case of the upward valuation of fixed assets there is a difference of opinion as to whether or not the resulting profit or surplus is available for distribution. Accountants seem to object almost instinctively to any inflations on the basis of market or appraised values. Fixed assets are required if a business is to operate, it cannot sell them, and no profit can be realized until they are sold. Therefore, accountants usually feel that dividends cannot be paid from unrealized profits resulting from writing up assets to a market value higher than cost. This idea is held even though some decisions of the courts may be found upholding the legality of such dividends. On the other hand, downward fluctuations of fixed assets, indicating a theoretical loss, need not be considered in determining profits available for dividends.

Some accountants suggest that if it is desired to give stockholders the benefit of increased market value of fixed assets, it would be much better to declare and pay a stock dividend. In that case, if profits eventually turned out to be losses, such losses could properly be charged against the capital stock issued under the form of dividends.

There is one case where it seems only just that unrealized appreciation of fixed assets be given consideration. Suppose that a corporation desires to market an issue of bonds, and that the fixed assets which are to stand as security for the issue have appreciated greatly. Then it seems fair to bring the appreciation on the books, but it must be remembered, however, that the appreciation should be credited to some special account and not be made to appear available for dividends.

While depreciation must be provided for, the same hardly can be said concerning the depletion of natural resources such as mines, oil wells, and timber tracts. It was held in the case of *Lee* v. *Neuchatel Asphalte Company* that a deduction for depletion did not have to be made before arriving at profit available for dividends. Most critics of this decision state that such a policy is not sound. However, investors in such enterprises are aware of the speculative nature of the enterprise and should know that its operations result in the production of a profit and also a conversion of a portion of their investment. Of course, if a company expects to be permanently engaged in such enterprises, it is a matter of policy as to the portion to be reserved from distribution in order that there may be capital with which to engage in other enterprises. One argument for deduction of depletion is that the Federal income tax law allows such a deduction.

Profits realized from extraneous operations may be distributed as dividends, but directors should inform stockholders, where such extraneous profits have made possible the dividend, that its source is not from operating profits, but from extraneous profits.

The availability for dividends of premium on capital stock is questionable. Certain writers classify premium as "contributed capital." At least one writer leads one to the conclusion that he considers such premium as essentially surplus, but denies that it is available for dividends. The law concerning premium is indefinite. In New York premium is looked upon as distributable profit, but in California it is considered part of "capital stock." Accountants probably are more on the side of regarding premium as available for dividends.

Accounting for deferred charges affects the amount of profit available for dividends. Prepaid expenses such as insurance premiums unexpired and prepaid rent and interest which apply to future periods should be charged to them. A deferred asset, such as cost of advertising which will benefit later periods, may be charged against profits of the future periods.

In England a company may pay dividends from profits of the current year, although losses of previous years have not been made good. The rule in this country seems to be that no dividends can be paid until the profits have exceeded past losses. Good business practice certainly would demand this.

In determining profits available for dividends, the accountant cannot disregard decisions of the courts, because of the risk that he may lead his client into an action for which the client may be held liable. Even though it appears that the courts are opposed to certain ideas that the accountant considers fundamental principles of his profession, still he cannot ignore their decisions.

Impressions of an American Accountant in Europe

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THE growing investments of American businesses in Europe and the large demand of European borrowers for American credit have opened a field to the American accountant that is wide in scope and affords a fine opportunity for service to the American lender, the European borrower, and the American business man with foreign interests.

However, the accountant trained and with experience in American procedure has much to learn about the methods em-